THE SAVINGS AND LOAN PROBLEM: A DISCUSSION OF THE ISSUES

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PREFACE

This memorandum was written by Daniel Kaplan, Mary Maginniss, Angelo Mascaro, Mark Booth, and Robin Seiler. It was undertaken in response to a request from the Committee on Ways and Means of the U.S. House of Representatives. The memorandum examines economic and budgetary issues concerning the savings and loan problem. Mimi Cantwell edited the paper and Margaret Cromartie typed the various drafts.

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INTRODUCTION

Although the Federal Savings and Loan Insurance Corporation (FSLIC) dealt with more than 200 bankrupt thrifts in 1988, the crisis is far from resolved. More than 300 insolvent thrifts still remain open, and many solvent thrifts are financially weak. Because FSLIC is insolvent, it has resorted to a variety of creative financing methods in dealing with many of the thrifts acquired with FSLIC assistance, and in the process, it has committed its premium income for many years to come. FSLIC has also left open many questions about both the final cost and the viability of some of the thrifts that have already been acquired.

An ultimate resolution would seem to require a different approach. The Bush Administration has recently put forth a comprehensive plan designed to close the remaining insolvent thrifts and institute a new regulatory structure. This Congressional Budget Office (CBO) memorandum attempts to put the thrift crisis into perspective by discussing the origin of the problem, reviewing estimates of the size of the problem, and exploring the present budgetary treatment of FSLIC and the treatment of alternative financing plans. Finally, the paper considers the issues that the Congress might address in developing an ultimate solution to the crisis.

In most industries, a firm that continually loses money will ultimately fail--it will eventually be unable to meet its current obligations. It might be able to survive for a time by selling assets or borrowing money. Both actions, however, reduce the owners' stake in the firm. And when the value of a firm's liabilities exceeds the value of its assets--that is, when the firm is insolvent--its creditors would generally value the firm more if it were liquidated than if it remained open.

In most industries, insolvent firms go out of business. Banks and thrifts are exceptions. Depositing funds in a federally insured institution is, from the individual's perspective, equivalent to purchasing a riskless asset. Thus, banks and thrifts that are allowed to remain open can borrow money even when they are insolvent. If the bank's or thrift's operations do not generate enough revenues to meet its obligations, depositors know that the federal government will meet them.

Deposit insurance, therefore, has an unfortunate side effect--it gives insolvent institutions an incentive to squander resources. A bank or thrift that has become insolvent because of a series of bad investments can attract the funds necessary to continue operating simply by raising its interest rates on deposits. Moreover, since the owners' stake in an insolvent thrift is worthless, the thrift has little incentive to use insured deposits prudently. It could use deposits not only to pay current obligations but also to back risky investments and inside deals; it could also use deposits to provide overly generous compensation to its employees.

In one sense, the thrift crisis is about the amount of money that the government must spend to back government-insured deposits with interest-bearing assets. But it is also about the squandering of private domestic savings in the future. The failure of insolvent thrifts to use deposits to make prudent investments means that the capital stock of the U.S. economy is smaller than it would otherwise be. And because the United States has a smaller capital stock, its residents will have less income both now and in the future.

The Origins of the Problem

The origins of the thrift crisis can be traced in large part to the inflationary era of the late 1970s and early 1980s, coupled with government regulations. During this period, interest rates rose dramatically. At the same time, the government limited the rates that thrifts could pay, causing depositors to shift their savings to money market funds and other investment vehicles in search of higher returns. In addition, the higher rates led to a sharp depreciation in the value of the assets of thrifts. The government mandated that thrifts keep most of their assets in fixed-rate mortgages, the bulk of which they had acquired when rates were much lower.

To help the industry respond to these developments, both the Congress and the Federal Home Loan Bank Board loosened their regulatory hold during the early 1980s. They gave thrifts more flexibility in determining the interest rates they could pay and the types of investments they could make.[1] In order to permit the industry to take advantage of its increased operating flexibility, the Bank Board also adopted policies to encourage growth.

The Bank Board largely controls the growth of thrifts by prescribing the amount of net worth--the difference between assets and liabilities--that institutions have to maintain. Specifically, the Bank Board establishes a minimum ratio of net worth (also called capital) to assets. The principal liability of a bank or thrift is its deposits. Thus, the smaller the capital-to-asset ratio, the more deposits a thrift can accept and the more assets it can acquire with a given amount of capital. In 1980 and again in 1982, the Bank Board reduced the capital ratio that thrifts had to maintain. For thrifts that had been operating for less than 20 years, as well as for those that were growing rapidly, the Bank Board adopted rules that had the effect of reducing capital requirements by even more. The Bank Board also eased capital constraints in the industry by allowing FSLIC-issued income capital certificates (ICCs) and net worth certificates (NWCs) to be used in computing a thrift's capital requirements.[2]

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1. The Depository Institutions Deregulation and Monetary Control Act in 1980 and the Garn-St Germain Depository Institutions Act of 1982 expanded the types of investments that thrifts were permitted to make. The earlier bill also phases out regulation of interest rates. A number of states, most notably Texas, Florida and California, had previously given their state-chartered thrifts expanded authority to make investments.

2. The Bank Board used more liberal Regulatory Accounting Principles (RAP) in establishing the net worth requirement rather than the more conventional Generally Accepted Accounting Principles (GAAP). By including intangible assets, in particular goodwill, even GAAP overstated the value of many of the thrifts. For the most part, this goodwill resulted from earlier acquisitions.

It is doubtful that the reduced capital requirements and the expanded lending authority would have been sufficient to enable the industry to right itself.[3] The difference between the thrift industry's cost of funds and the yield on its assets was simply too large. Although interest rates began to decline rapidly in 1982 and much of the industry returned to profitability, not all thrifts shared in the general revival. In particular, the decline in oil prices and the resulting economic difficulties in the Southwest led to deteriorating asset values for many thrifts in that region.

The decline in interest rates did not end the thrift crisis. A number of institutions remained in very weak financial positions. Moreover, the desire to minimize government intervention in the marketplace, coupled with budgetary pressures, led to a reduction in the Bank Board's oversight of the industry. Thus, at the same time that the government expanded the bounds of permissible behavior, it devoted fewer resources to monitoring the conduct of the thrift industry. More significantly, the Bank Board reduced its oversight at a time when a large segment of the industry remained financially weak and had substantial incentives to misuse government-insured deposits. As a result, the thrift crisis is now more one of asset quality and less a problem of high interest rates, as it was at the beginning of the decade.

The Dimensions of the Problem

The previous discussion suggests that a resolution to the thrift crisis has two dimensions. One involves recognizing the losses of insolvent thrifts that have already occurred and determining how these losses should be paid for. Although the insolvent thrifts' assets are worth less than their liabilities, depositors perceive that their deposits are fully backed. An ultimate resolution means that interest-bearing assets are sufficient to back deposits at all thrifts. Since both FSLIC and the thrifts responsible for the crisis are insolvent, these losses must be covered by other segments of the economy.

The second dimension involves limiting future losses. Only by limiting the incentives and the ability of financial institutions to misuse government-insured deposits can a recurrence of the problem be avoided. Such actions would affect those currently insolvent institutions as well as those that will face financial difficulty in the future. Limiting the misuse of funds by currently insolvent or thinly capitalized thrifts reduces the cost of the ultimate resolution.

The Bush Administration recently announced a plan to address both of these dimensions. It proposes raising $50 billion in the private credit markets that, along with direct Treasury payments for any additional needs, would be used to pay for previous commitments as well as to close all currently insolvent thrifts over the next three years. The Bush plan also includes provisions that would strengthen the regulatory and insurance structure of the savings and loan industry to limit risktaking and to restore solvency to the fund.

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3. See, for example, R. Dan Brumbaugh, Jr. and Andrew S. Carron, "Thrift Industry Crisis: Causes and Solutions," Brookings Papers on Economic Activity, no. 1 (1987), pp. 344-379.

Within days of announcing this plan, the Bank Board, which operates FSLIC, contracted with the Federal Deposit Insurance Corporation (FDIC) to give FDIC control of thrifts that are insolvent. Examiners from several federal agencies are forming teams to help FSLIC stabilize these thrifts. The Bank Board has also suspended sales of insolvent institutions, although it is still liquidating institutions. Most of the reforms proposed by the Bush plan require legislation, however, and the Congress will have a number of policy and budgetary issues to examine in the context of developing a rescue plan.

THE SIZE OF THE PROBLEM

To resolve an insolvent thrift, the government must eliminate the gap between the institution's liabilities and its assets (an insolvent thrift is resolved by either liquidating it, or by providing another firm with financial assistance to acquire it). In other words, the government must ensure that interest-earning assets back the insured deposits. The ultimate cost of resolving the thrift crisis, therefore, will be roughly equal to the combined negative net worth, on a market-value basis, of all insolvent thrifts when each thrift is resolved. At any time, the rate at which the net worth of the remaining insolvent thrifts deteriorates reflects the cost of delaying a resolution.

Estimating the ultimate cost of a resolution, however, is extremely difficult. It is even difficult to determine the cost of resolving many institutions that have already been dealt with. The fundamental reason is that thrifts report the book value of their assets--which is based on their historic cost--while the government's cost liability depends on those assets' market value at the time of sale. For specialized assets, like incomplete office buildings and idle equipment, only a sale can establish the market value, and it may take years before all the assets are sold. In addition, payments on the notes and guarantees that FSLIC issued when it resolved many of the institutions depend on future interest rates and asset values, as well as on the timing of asset sales.

FSLIC estimates that it has committed $38 billion, in present value terms, to resolve nearly 300 thrifts over the past three years.[4] FSLIC also states that acquirers of insolvent thrifts received, on a net present value basis, more than $5 billion in tax preferences for deals made in 1988 alone. As the result of its efforts, FSLIC has not only exhausted its reserves, but has also more than committed its future premium income, though substantial costs remain to be met. Moreover, many currently solvent thrifts will most likely become insolvent over the next several years (see Table 1). A significant segment of the industry, although solvent, is thinly capitalized and not profitable. Resolving the thrift crisis will also entail dealing with these institutions. In addition, FSLIC must replenish its reserves and meet its commitments. Increasing

4. Present value calculations are used to estimate the value of a stream of income or liabilities that will occur in the future, allowing comparisons of streams of dollars that occur at different points in time. All numbers except those related to budgetary treatment are in present value terms, unless otherwise indicated.

TABLE 1. SOLVENT THRIFTS CLASSIFIED BY THE RATIO OF CAPITAL TO ASSETS, SEPTEMBER 30,

	GAAP Capital as a Percentage of Assets		
	Less than 3 percent	Between 3 and 6 percent	Greater than 6 percent
Number of Firms	379	972	1,239
		In Billions of Dollars	
Total Assets	277.2	630.3	318.6
Tangible Capital	-0.9	16.7	21.8
Net Operating Income - Nine Months Ending 9/30/88	-0.1	2.4	2.5

SOURCE: Congressional Budget Office based on Federal Home Loan Bank Board data.

NOTE: Solvent thrifts are those with capital greater than zero, according to Generally Accepted Accounting Principles (GAAP).

the rate at which insolvent thrifts are resolved, as well as changing the methods used to resolve them, may reduce the cost of solving the problem.

Estimating the Government's Current Liability

A number of existing estimates of the cost of the thrift crisis are discussed below. For the most part, they entail a present value cost of at least $100 billion. This includes the cost of resolving financially weak thrifts, as well as those that have already been acquired or liquidated. It also includes funds to at least partly replenish the reserves of the FSLIC insurance fund. Part of these costs have already been paid for, as FSLIC disbursed $16 billion in cash from 1986 to 1988 for case resolution. Thus, if the total cost of the problem is in the range of $100 billion, the federal government would need to spend about another $85 billion in net present value for these purposes. The Administration's estimates project assistance under its plan of roughly that amount.

Estimates of the resolution cost have been derived in two ways. One relies on FSLIC estimates of the cost of resolving previously insolvent thrifts to project the cost of future case resolutions. The other approach involves estimating the negative net worth of an institution either by writing down its assets--that is, reducing their value on the thrifts' books--or by valuing its future income flows.

Regardless of the approach, the estimates must be viewed with caution. For example, the cost of resolving currently insolvent thrifts may differ significantly from the costs for those that have already been resolved. As has already been noted, the historic resolution costs are, in fact, estimates (see Table 2). In addition, some previously resolved thrifts may fail again; thus, the initial estimate of the cost of resolution will have been too low. The FSLIC cost data also do not include various tax advantages given to acquirers of insolvent institution. Finally, the insolvent thrifts' operating data may not be reliable.

Federal Deposit Insurance Corporation. FDIC insures commercial banks and thus has substantial experience in estimating the cost of resolving insolvent financial institutions. FDIC estimates that the ultimate cost of the crisis on a present value basis will range between $80 billion and $105 billion, noting that a recession or significant increase in interest rates will increase the cost still further. It accepts FSLIC's estimates of the ultimate cost of those thrifts that have already been resolved (see Table 3). It further estimates that it will cost an additional $30 billion to $50 billion to resolve the remaining insolvent thrifts.[5] Finally, FDIC believes that an additional $10 billion to $15 billion will be needed to recapitalize FSLIC.

FDIC derives its estimate of the cost of resolving currently insolvent thrifts by using the method it developed to estimate the cost of resolving bank failures. The procedure applies a loss rate to various classes of assets whose value is uncertain. For example, no loss rate is applied to cash, marketable short-term securities, or residential mortgages. A loss rate of 20 percent is applied to other assets that have

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5. See testimony of L. William Seidman before the Committee on Banking, Finance and Urban Affairs, House of Representatives, January 26, 1989.

TABLE 2. RESOLVED AND REMAINING INSOLVENT THRIFTS

	Calendar Year in Which Cases Were Resolved			Remaining Insolvent Thrifts
	1986	1987	1988	
Number of Firms	47	47	205	351
	In Billions of Dollars			
Total Assets	12.5	10.5	100.6	107.0
GAAP Capital	0.8	2.0	9.5	11.5
Tangible Capital	-1.1	-2.3	-12.7	-14.6
Resolution Cost a/	3.1	3.7	31.2	n.a.

SOURCE: Congressional Budget Office based on Federal Home Loan Bank Board data.

NOTE: Insolvent thrifts are those with capital less than zero, according to Generally Accepted Accounting Principles (GAAP).

n.a. = not available.

a. Present value, as estimated by FSLIC.

TABLE 3. ESTIMATES OF THE COST OF RESOLVING THE THRIFT CRISIS
(In billions of dollars)

Estimator	Cost	Comment
Federal Deposit Insurance Corporation	80-105	Includes FSLIC liabilities from 1988; resolutions of remaining insolvents; capital reserves for FSLIC insurance fund.
General Accounting Office	112	Includes FSLIC liabilities; resolution of remaining insolvents; capital reserves for FSLIC insurance fund.
Lowell Bryan	over 100	Total net present value cost of resolving all thrifts.
Bert Ely	75-80 a/	Net present value of FSLIC liability for past or future insolvents as of January 1989. Does not include capital reserves for FSLIC insurance fund.

SOURCE: Congressional Budget Office.

a. The cost could be $100 billion if resolution is delayed and if some resolved thrifts fail again.

not been adversely classified by examiners. Higher loss rates are applied to classified assets, depending on examiner evaluations. These losses may be further adjusted, depending on the geographic location of the institution.

General Accounting Office. The General Accounting Office (GAO) estimates that the thrift crisis would require, as of January 1, 1989, at least an additional $85 billion above the $27 billion it estimated that FSLIC would have available through 1998 to pay insurance losses.[6] Thus, it calculates the total cost to be $112 billion. The additional $85 billion includes $34 billion to resolve insolvent thrifts that are still operating, $26 billion for unfunded actions by FSLIC in 1988, $20 billion to replenish the fund, and $5 billion for insolvent thrifts not currently identified.

GAO bases its estimate on its calculation of the size of the problem on January 1, 1988. For institutions resolved through September 30, 1988, GAO determined FSLIC's average cost per dollar of assets for the past several years. It distinguishes between thrifts in the FSLIC case load (those that the FSLIC is attempting to resolve) and other insolvent thrifts, and then it applies a different ratio to each group.

Lowell Bryan. Lowell Bryan of McKinsey and Company estimates that the total cost of resolving insolvent institutions will ultimately be more than $100 billion in present value terms.[7] He calculates that the commitments that the FSLIC has already made and the tax benefits that acquirers received are worth $50 billion. Thus, he believes that perhaps as much as half of the total cost has already been borne.

Mr. Bryan uses a variety of methods to calculate the total cost. These include estimating the excess of liabilities over earning assets, as well as capitalizing expected cash flows. He also uses FSLIC resolution costs as a percentage of negative operating income (instead of assets as GAO does) to compute the cost of resolving currently insolvent institutions. He reports that each method produced a total cost estimate in excess of $100 billion, but he does not report the results from each method separately. Mr. Bryan's estimate includes the resolution of thrifts that led to the depletion of the insurance fund. Therefore, implicitly it includes the fund's recapitalization.

Bert Ely. Bert Ely, a private consultant, concludes that the cost of resolving the currently insolvent thrifts would be $75 billion to $80 billion, as of the end of 1988. This estimate assumes that the thrifts are closed rapidly and that no resolved institutions subsequently become insolvent. Since he does not view either of these conditions as likely, he says that the cost could approach $100 billion. His estimate does not include the cost of restoring the reserves of the insurance fund. Mr. Ely's estimate is an average of two methods. One involves marking down assets and the other involves capitalizing an estimate of the future stream of income. He also does not separately report the results of each approach.

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6. See testimony of Charles Bowsher before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, February 2, 1989.

7. See testimony of Lowell Bryan before the Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, January 31, 1989.

The Cost of Delay

In a fundamental sense, the entire thrift crisis is a cost of delay. If insolvent institutions had been resolved as soon as they had become insolvent, the cost would have simply been the administrative expenses associated with the resolutions. Insolvent thrifts, and especially those with a history of operating losses, only rarely return to financial health. For example, there were 181 thrifts insolvent in 1985 that were still insolvent in the third quarter of 1988. During this period, the negative net worth of these institutions decreased at an average annual rate of 40 percent (see Figure 1). These data are based on book value, and thus some of the decline results from the write-down of assets.

The cost of delay stems from two types of thrift activities: managing the existing stock of assets and acquiring additional assets. The nature of the costs from each type of activity differs significantly. Resolving institutions rapidly is one way to limit the cost of delay. Controlling investments by insolvent thrifts is another.

Servicing Existing Assets. Most insolvent thrifts have operating losses--that is, the income generated by the assets of the thrifts does not cover their costs, such as interest on deposits and operating expenses. This operating loss is largely covered by increased deposits. Since the added deposits are used to cover costs, they do not result in a corresponding increase in asset value, and accordingly the thrifts' net worth declines. The increase in deposits will increase interest expense, and as a result, assuming nothing else changes, operating losses of thrifts will increase in the next period. As this process continues, the thrifts will have to face ever-increasing interest expenses, which in turn requires ever-increasing deposits. Consequently, the net worth of insolvent thrifts will tend to decline by ever-increasing amounts.

A rough approximation of this aspect of the cost of delay can be computed. The operating income of a thrift is equal to what it earns on its assets minus its interest expense and its operating costs. Based on reported data for the 350 insolvent firms that remain open, the cost of delay would be more than $3 billion a year if 75 percent of their reported assets actually earned income.[8]

Of course, a change in the value of a thrift's assets will also change its net worth. For example, a sustained recovery in world oil prices would undoubtedly lead to an improvement in the Southwest's economy and the value of the assets held by thrifts in that region. On the other hand, some risky investments take some time to fail. This is especially true when a financial institution lends funds to a venture so that it can make payments on its loan.[9]

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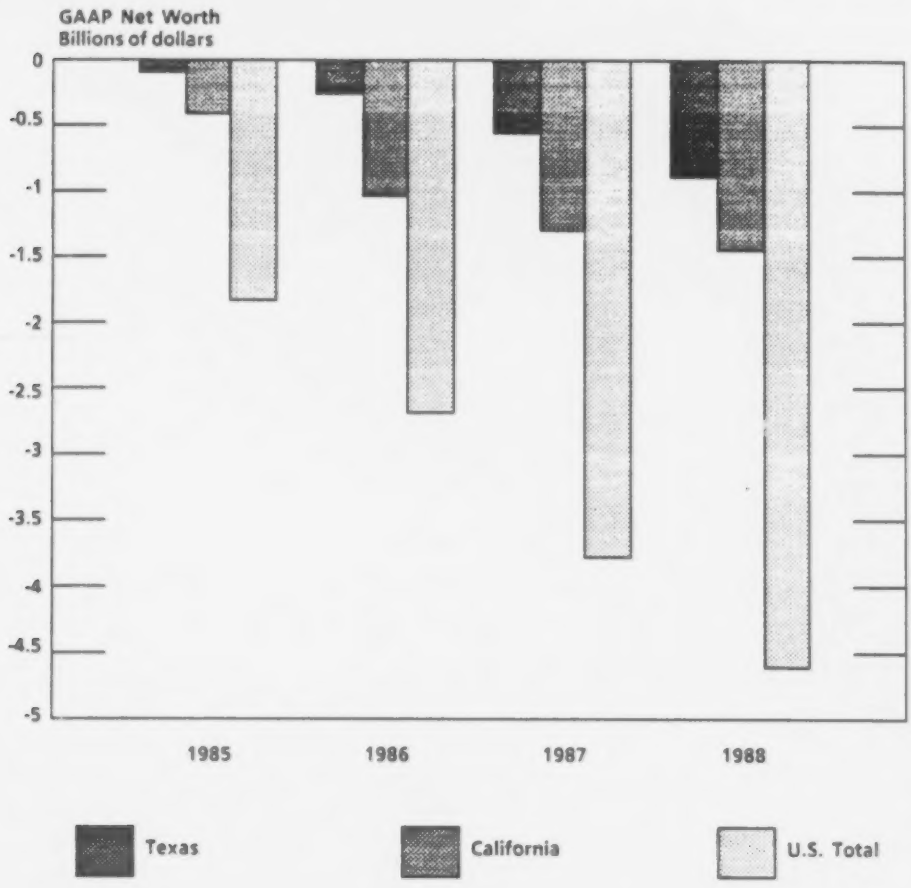
8. This cost is based on the reported assets and liability of those thrifts, as well as their cost of funds and yield on assets in the third quarter of 1988. Among insolvent thrifts, the ratio of interest-bearing assets to interest-bearing liabilities was about 75 percent.

9. For a discussion of this issue, see the testimony of Lowell Bryan.

Figure 1.
Unresolved Insolvent Thrifts, 1985-1988



SOURCE: Congressional Budget Office based on Federal Home Loan Bank Board data.

Acquiring New Assets. A real possibility exists that the losses will continue to increase for another reason as well--insolvent thrifts have incentives to make overly risky investments. Without a dramatic increase in the value of its existing assets, an insolvent thrift will not be able to reach a positive net worth unless it acquires additional assets. In that case, the thrift would use the increased deposits to acquire additional assets. Such a transaction does not decrease real net worth unless the value of the asset declines. Yet, insolvent thrifts have incentives to make risky investments. They are essentially gambling with someone else's money, but they benefit if the investment generates a large payoff. Of course, the institutions became insolvent in the first place largely because of bad investments.

Using deposits to fund current expenditures and using additional deposits to make overly risky investments are both costs to society from delaying the resolution of an insolvent thrift. An important distinction exists between the two--one is avoidable and the other is not. To continue operating, an insolvent thrift must borrow to cover its expenses; these costs, however, may be controllable. It does not, however, have to make additional risky investments to serve its existing depositors.

How FSLIC has Dealt with the Crisis

FSLIC has used two basic methods to fill the gap between an insolvent thrift's liabilities and its assets. The first is simply to liquidate the institution. While in practice a liquidation can take a variety of forms, in its simplest form, FSLIC pays off the various deposits and then collects the proceeds from the sale of the defunct thrift's assets.[10] The former depositors then redeposit their funds in another institution that uses them to acquire additional assets. The cost of such a liquidation, therefore, is roughly equal to the difference between the market value of the thrift's assets and its liabilities--that is, its negative net worth. The second method of resolving a thrift involves FSLIC providing financial assistance to another firm to acquire the insolvent thrift. FSLIC has tended to emphasize such assisted acquisitions because, among other things, it has limited resources and because tax advantages can only be used in acquisitions (see Table 4). Yet, in many cases, liquidations may have been less expensive.

Comparing the Cost of Assisted Acquisitions and Liquidations. By law, the cost to FSLIC is the major consideration in determining how to resolve an insolvent thrift. Assisted acquisitions are generally cheaper to FSLIC, but not necessarily to the government. In the first place, even insolvent thrifts have a core of customers, both borrowers and lenders, that have value to an acquirer. This value can be most easily captured through an acquisition. In addition, the Congress has awarded tax advantages to acquirers of insolvent thrifts that reduce the cost to FSLIC, but not to the government. FSLIC also emphasizes assisted acquisitions because they require smaller initial cash outlays. A depositor in a liquidated thrift must be paid in cash, while an acquirer can be paid with notes and guarantees. FSLIC, which is itself

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10. Another type of liquidation involves FSLIC transferring deposits to another institution and giving that institution the physical assets of the thrift (primarily the branches) and a combination of cash and notes from FSLIC.

TABLE 4. PAST RESOLUTIONS OF THRIFTS BY FSLIC
(By calendar year, in billions of dollars)

	Assisted Acquisitions			Liquidations		
	1986	1987	1988	1986	1987	1988
Number of Firms	26	30	179	21	17	26
	In Billions of Dollars					
Total Assets	6.4	7.6	97.7	5.9	2.9	3.0
Total Resolution Cost (Present value) a/	0.5	1.4	28.3	2.5	2.3	2.8

SOURCE: Congressional Budget Office based on FSLIC Case Resolution Report (December 1988).

NOTE: Figures are estimates and do not include the costs of tax benefits given to acquiring firms.

a. Present value, as estimated by FSLIC.

insolvent, has only limited cash available.[11]

In the long run, however, assisted acquisitions may not always be the least costly approach. Factors other than the insolvent firm's negative net worth at the time of resolution may make liquidation the lower-cost method. For example, if the assisted acquisition creates a firm that does not have the incentives to perform efficiently, the ultimate cost of resolution can increase sharply. If the "resolved" firms do not have sufficient capital, the new owners might, like their predecessors, use insured deposits to finance overly risky projects and to pay excessive levels of compensation. Even if operated prudently, such firms might not be able to withstand the shock of a sudden increase in interest rates or a downturn in the economy. In the case of some insolvent thrifts, it may simply not be possible to structure an assisted acquisition that would attract sufficient capital.

In addition, in some cases, FSLIC has tied the cost of the ultimate resolution to the actions of the assisted thrift. At the same time, it has given the thrift little incentive to try to control these costs. Specifically, through the use of yield maintenance agreements and capital loss guarantees, FSLIC has guaranteed the performance of a specified group of assets. The primary reason for the use of these provisions is that neither the Bank Board nor potential acquirers have been able to evaluate adequately the assets of these thrifts.

The reason these agreements have perverse incentives is straightforward. Under a yield maintenance agreement, any income generated by a covered asset will lead to a reduction in payments from FSLIC. Under some of the agreements, the institution may receive the same revenues whether or not scheduled payments under outstanding loans are made. In such a case, the government receives the benefit of any payments made on the asset. The title, however, remains with someone who has a much smaller interest in whether these payments are actually made. A capital loss guarantee similarly distorts the assisted thrifts' incentives with respect to the sale of assets. In fact, a capital loss agreement can actually encourage fraudulent behavior since it can reduce the cost of selling an asset to a friend or colleague to a price below market value.

FSLIC has tried to rectify these problems with its asset guarantees by introducing a limited amount of revenue and loss sharing into its yield maintenance and capital loss guarantees. Under these provisions, a thrift's revenues will increase by some percentage of any increase in payments made on covered assets. Nevertheless, unless a thrift's revenues increase by the full amount of the increased payments, it does not have the incentive to devote sufficient resources to maintaining the value of its assets.

The Tax Benefits. The Congress has enacted a number of tax provisions that reduce the cost of an assisted merger to FSLIC. To the extent that these tax savings do not lead to an equivalent reduction in FSLIC expenditures, however, they increase the government's ultimate cost of resolution. Moreover, as discussed later, they may

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11. At the end of 1987, the latest data available, FSLIC had a negative net worth of $13.7 billion. With the deals completed in 1988, this negative net worth has probably tripled.

lead the government to award the insolvent thrift to the wrong bidder.

Some of these tax provisions reduce the taxes of a firm that acquires an insolvent thrift. For example, FSLIC assistance payments to an acquirer of a troubled thrift are not considered taxable income for purposes of the regular corporate income tax.[12] In addition, an acquirer of an insolvent thrift can more easily reduce current and future tax liabilities by using the insolvent thrift's net operating losses (NOLs) in previous years. The acquirer can similarly use built-in capital losses--that is, capital losses that are not realized for tax purposes at the time of acquisition.

To qualify for use of these NOLs and built-in losses, the acquisition must meet certain conditions set by the tax code. In particular, the transaction must be deemed a nontaxable reorganization--that is, the shareholders of the acquired firm must maintain a significant ownership interest in the newly combined firm. Since many savings and loan associations are mutually owned, this ownership requirement is not satisfied. A special tax rule, however, allows transferred deposits to count as stock ownership in the newly combined institution. Even if the acquisition of a thrift were to qualify as a nontaxable reorganization, the NOLs and built-in losses would not, under ordinary circumstances, transfer to the acquirer if the acquired firm has zero or negative net worth. The Congress has enacted another special tax rule that exempts acquisitions of insolvent thrifts from this restriction.

These tax benefits are potentially quite valuable to the acquirer. For example when assets with built-in losses are also covered by FSLIC capital loss guarantees, an acquirer would benefit from the tax-free treatment of the loss guarantee (assistance payment) and from the ability to deduct built-in capital losses against other capital gains. In order to restrict the use of these combined tax benefits, the Congress enacted a 50 percent cutback in the Technical and Miscellaneous Revenue Act of 1988. This cutback reduced the amount of NOL, interest, and capital loss deductions by up to 50 percent of FSLIC assistance payments.[13]

The Bank Board has estimated that the sale of insolvent thrifts in 1988 could result in tax losses with a present value of $5.8 billion. Estimates of such tax losses are very uncertain. This uncertainty arises in part from legal questions about the

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12. Without the special rule, such payments most likely would be taxable in the year received. The tax law is unclear and has not been conclusively resolved by the courts. Depending on how they are used, the amount of assistance payments may have to be included in future capital gains. This treatment would result in deferral of tax rather than complete tax exemption. Since payments may be partly included in taxable income for computing the corporate alternative minimum tax, some tax may be paid on assistance payments.

13. At the outset, any NOLs are reduced by up to 50 percent of assistance payments. If this step does not result in an NOL restriction of 50 percent of the assistance payments, then interest deductions are reduced. If the available NOL and interest deductions are not large enough to absorb a full 50 percent cutback, then the built-in losses (when realized) are reduced.

proper interpretation of how "normal" tax law would apply to the acquisition of insolvent thrifts, as well as from uncertainty about the precise magnitudes of the tax attributes of both insolvent thrifts and their acquirers. Moreover, because of the changes in the tax laws, effective in 1989, estimates of tax losses associated with deals in 1988 will provide only limited information about the tax consequences of future resolutions.

THE IMPACT ON THE BUDGET

Because FSLIC is a federal agency, any plan to raise funds to address the current crisis must be considered in the context of the federal budget process. Unlike most of the estimates cited earlier, which are on a present value basis, the federal budget largely reflects cash flows. A description of the current budgetary treatment as well as that of the Bush plan follows.

Current Budgetary Treatment

As a government entity, FSLIC's activities are fully reflected in the federal budget. Its income and expenditures are recorded in a revolving fund that was intended to be self-supporting. Income from assessments, investments, and liquidations is used to pay insurance and administrative costs. Net outlays each year are the difference between FSLIC's receipts and disbursements. FDIC transactions are treated the same way.

Until the early 1980s, annual receipts to FSLIC were generally greater than its expenditures. As a result, net outlays were usually negative, thereby reducing the federal budget deficit. Since 1985, FSLIC's net outlays have been positive, reaching $8.1 billion in fiscal year 1988 and totaling $13.8 billion over the 1980-1988 period.

The Financing Corporation (FICO). As FSLIC spending increased to deal with the growing number of failing thrifts, the agency consumed most of its cash resources. The Competitive Equality Banking Act of 1987 created the Financing Corporation (FICO), a new government-sponsored enterprise, to borrow $10.8 billion from the financial markets in amounts not to exceed $3.75 billion a year. The proceeds are to be conveyed to FSLIC for closing or assisting in the acquisition of insolvent thrifts.

To date, FICO has issued $5.85 billion in 30-year bonds for this purpose. Payments of principal on this debt will be made from funds set aside at issuance and invested in zero-coupon U.S. Treasury securities. Interest on the FICO debt is paid from assessments levied by FICO on federally insured savings and loans--amounts that would otherwise be paid to FSLIC.

FICO is off-budget because it was considered to be owned by the Federal Home Loan Bank system, a privately owned government-sponsored enterprise. Because FSLIC is not required to repay the funds it receives from FICO, they are treated as offsetting collections to the FSLIC fund--which means that they offset, dollar for dollar, the increased FSLIC disbursements they finance. As a result,

financing FSLIC spending by issuing FICO bonds has no apparent net effect on the budget.

This budgetary treatment--particularly the determination that FICO is not a government entity--raises many questions. FICO has a number of characteristics of a government entity: it was established by federal law, is controlled by government officials (the Bank Board), exists solely for the purpose of financing a governmental activity, and has the authority to levy and collect assessments from insured institutions. On the other hand, its only capital is derived from the Federal Home Loan Bank system, which is its nominal owner and is itself privately owned; moreover, FICO's obligations are not obligations of the United States. In the end, the budgetary treatment was based on the criterion, adopted in 1967 by the President's Commission on Budget Concepts, that "privately owned" entities should be off-budget.

FICO's structure was developed for no other reason than to avoid any unified budget impact in the initial years of the refinancing program. Had the assistance instead been financed through Treasury borrowing, FSLIC's expenditures would have been the same, but no offsetting collections would have been scored. As a result, FSLIC's net outlays would have increased in the years that the borrowed money was spent. This arrangement has a cost, however, because the financial markets have demanded a higher interest rate on FICO bonds than on Treasury securities--ranging from 69 to 109 basis points higher. On $10.8 billion in bonds, this differential will cost the government about $100 million per year over 30 years.

FSLIC Notes. FSLIC's shortage of cash has forced it to issue notes to acquirers of failed institutions. These notes are generally for a 10-year term, and they typically bear interest at a variable rate somewhat in excess of the local cost of funds. As of December 31, 1988, FSLIC had about $20 billion in notes outstanding.

The federal budget includes the entire amount of these notes as outlays when they are issued, even though cash payments for principal may not be made for 10 years or more. The issuance of a note is treated as a cash outlay by the government to the acquirers, and a simultaneous borrowing back of the cash. (The proceeds of borrowing are not counted as receipts in the budget.) Since the spending financed by the notes is recorded as outlays when the notes are issued, the use of cash to pay off the notes is not treated as an outlay (as is the payment of principal on Treasury bills). Interest payments, on the other hand, add to the deficit when they are paid.

FSLIC Guarantees. Along with cash and notes, an assistance package may also include agreements to maintain yields on acquired assets to cover an acquiring institution's cost of carrying nonperforming loans. In addition, FSLIC may promise that after an asset is sold, it will pay the difference between the realized value and the book value for these covered assets. CBO views the initial commitment to guarantee a yield and to cover the losses on these assets as a contingent liability, because the timing and amount of yield and capital loss payments are uncertain. As in the case of loan guarantees, the budget records outlays for such contingent liabilities only when losses occur.

Lacking sufficient cash, FSLIC expects to defer payment on most capital losses for up to 10 years, although new owners are likely to begin disposing of covered assets far earlier. CBO believes that the budget should recognize these capital losses as outlays when an asset is sold and its value is no longer uncertain. (The commitment to pay for that loss with interest at some later date is a form of borrowing.)

CBO Baseline Projections

The extent to which FSLIC can continue to address the thrift crisis by using massive amounts of notes and guarantees is uncertain. The CBO baseline estimates for FSLIC assume that the agency, in the absence of legislation, will continue to issue promissory notes but will also be forced to borrow, most likely through the Federal Home Loan Bank system, to finance its activities. Thus, if legislation to provide cash to FSLIC is not enacted, the agency will be forced to rely on three types of borrowing: its own notes, borrowing from the Federal Home Loan Bank system, and FICO borrowing from the public. The financing costs of all this borrowing would have significant budgetary implications, and the interest rates would be higher than Treasury borrowing costs. To pay interest on FICO bonds, the off-budget borrowing would siphon off future assessment income, and interest on the borrowing from the Federal Home Loan Bank system would consume the remaining assessment income. After paying interest on its notes, FSLIC would be left with massive levels of future debts and little cash for resolution costs.

Under baseline assumptions, CBO projects that FSLIC will spend about $63 billion for assistance, $16 billion for interest costs, and $2 billion for administrative expenses over the next six years. Offsetting these disbursements are an estimated $28 billion in collections, including $10 billion from liquidating assets, $8 billion from assessments, $7 billion from proceeds from FICO borrowing, and $2 billion in other income. FSLIC borrowing over this period is assumed to total almost $31 billion. The cumulative effect of this activity is expected to increase the deficit by $54 billion from 1989 through 1994 (see Table 5).

While the baseline reflects the intent of the Bank Board to continue to merge or close as many institutions as possible from its current case load, it does not include sufficient funds to resolve, at the least cost to the federal government, all those thrifts that will need assistance. On a present value basis, the CBO baseline includes $45 billion to $50 billion in spending for case resolution, including disbursements in 1989 and beyond for commitments made in 1988 and earlier years. Thus, substantial additional cash is likely to be needed to resolve the industry's problems.

Potential Sources of Additional Cash

The budgetary impact of any plan to provide additional resources to FSLIC might or might not increase the deficit, depending on the details of the financing plan. If FSLIC could increase its income by raising its fees or charging new ones, the added receipts could be used to close or merge insolvent thrifts, and the net budgetary impact would be zero. Similar results would be obtained if funds were conveyed to

TABLE 5. CBO BASELINE FOR FSLIC (By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994	1989-1994
Disbursements	20.5	17.2	15.0	10.1	9.7	8.8	81.3
Collections	-7.5	-6.8	-3.4	-3.3	-3.2	-3.3	-27.5
Net Outlays	13.0	10.4	11.6	6.8	6.5	5.5	53.8

SOURCE: Congressional Budget Office.

FSLIC from the Federal Home Loan Bank system, or from an off-budget financing entity, as long as the transaction could not be construed as a form of borrowing by FSLIC.

The effect on the deficit from additional cash provided through Treasury or FSLIC borrowing would depend on how the cash is used. If cash were used to pay old notes, or substituted for new notes or rollovers on the capital losses, there would be no effect on the deficit relative to the CBO baseline because these transactions have already been counted in the spending totals. On the other hand, to the extent that FSLIC uses the cash to change its approach to resolving cases, such as by providing more cash up front, doing more liquidations, or resolving cases faster, outlays in the short term would increase.

The Bush Administration's Proposal

Details about the President's plan for the savings and loan industry have just recently become available, and in the absence of specific legislative language, there is uncertainty about a number of the plan's features. As a result, this review of the plan is preliminary; this and other proposals will continue to be studied to provide further estimates.

The Bush Administration would create a new corporation to raise $50 billion to close all currently insolvent savings institutions. This Resolution Financing Corporation (REFCORP) would sell 30-year bonds in the financial markets, with the proceeds going to a new Resolution Trust Corporation (RTC), which would resolve the insolvent thrift institutions insured by FSLIC. The proposal would involve the commitment of almost $90 billion more in cash over the 1989-1994 period than the Reagan budget. Of this amount, $50 billion would come from the REFCORP bond issue; $3 billion from additional assessment and liquidation income to the FSLIC; $4 billion from retained earnings of the Federal Home Loan Banks (FHLBs); and $31 billion from the Treasury (see Table 6).

Because the Treasury becomes the major source of funding, the financing mix in the years after 1994 is significantly different. Of about $66 billion in cash needed in the 1995-1999 period, the Administration estimates that $18 billion would be provided through FSLIC assessments and other income, and from FHLBs' retained earnings. The remaining $48 billion would be provided by the Treasury.

REFCORP Financing. REFCORP would provide the largest amount of new cash. The principal on its $50 billion in bonds would be paid by purchasing U.S. Treasury zero coupon bonds that, upon maturity, would be worth $50 billion. The cost of zero coupon bonds, estimated by the Administration to be $6 billion, would be financed from retained earnings of the FHLBs and FSLIC income. Interest on the REFCORP bonds would also be paid from several sources--earnings of the FHLBs, income from new liquidations, and the majority by the Treasury. Depending on interest rates and the timing of the financing, the interest costs are likely to be $4 billion to $5 billion per year. On a present value basis, these interest payments would account for close to 90 percent of the debt-service costs on the REFCORP bonds.

TABLE 6. SUMMARY OF THE BUSH ADMINISTRATION'S PROPOSAL RELATIVE TO THE REAGAN BUDGET, FISCAL YEARS 1989-1994 (In billions of dollars)

Sources of Cash	Value	Uses of Cash	Costs
REFCORP bonds	50	Additional case resolutions	43
Treasury	31	Substitution of cash for notes and other borrowing	22
Federal Home Loan Banks	4		
Additional liquidation income	3	Interest payments on REFCORP bonds less reduced interest on FSLIC notes	13
Additional assessments on thrifts	a/	Purchase of zero coupon securities to pay principal on REFCORP bonds	6
Total Sources	88	Provision of additional capital to FSLIC	3
		Total Uses	88

SOURCE: Congressional Budget Office based on Administration projections.

NOTES: Details may not add to totals because of rounding.

The table is based on Administration projections of expenditures and receipts for the various items; it does not reflect CBO economic assumptions or any other possible reestimates.

Neither sources nor uses include interest on Treasury borrowings needed to finance the $31 billion Treasury contribution shown above. Additional interest costs to the Treasury for this purpose would total about $5 billion from 1989 to 1994 under the Administration's economic assumptions. This amount would be in addition to the Treasury's share of interest payments on the REFCORP bonds, which is included above.

a. Less than $500 million.

Industry Resources. The Administration would require the FHLBs to funnel about $3 billion in current and future reserves to buy zero coupon bonds which, when they mature, would cover a portion of the $50 billion principal, and another $1 billion to cover part of the interest on the bonds. The rate paid by thrifts for insurance premiums would be raised from $2.08 to $2.30 per $1,000 in deposits in 1991, 1992, and 1993, and would then be reduced by 50 cents in 1994. The Administration estimates that additional assessment income would total about $0.4 billion during that time. Additional liquidations are expected to contribute about $3 billion to help finance the assistance program. Total receipts from these sources, above those projected under the Reagan budget, would be about $7 billion over the 1989-1994 period, and close to zero in the following five years.

Treasury Financing. All other cash needed by FSLIC and RTC in the 1989-1994 period, other than the $57 billion from the sources discussed above, would come from the Treasury. It is not now clear whether the legislation proposed by the Administration will require appropriations for this financing, or whether the agency would have permanent borrowing authority from the Treasury.

Treasury funds would be used to cover any shortfall in the interest payments on the REFCORP bonds, which the Administration estimates will cost the Treasury about $6 billion through 1994, and about $16 billion in the following five years. In addition, the Treasury would have to cover the cash shortfall in the FSLIC fund--the amount by which FSLIC's cash disbursements (including principal payments on old notes) exceed collections--and provide funds to increase the capital of the insurance fund. The cash supplied to FSLIC would amount to about $25 billion over the 1989-1994 period, assuming that the estimated payments on commitments for old and new cases in the Reagan budget are correct. Large cash payments that remain beyond 1994 are also expected to require Treasury financing. These would total about $48 billion over the following five years--$19 billion for principal on notes, $16 billion for interest on REFCORP bonds, $5 billion for additional capital for FSLIC, and $8 billion to cover other FSLIC and RTC cash requirements during that period. If the difference between future collections and disbursements is greater than that estimated by the Administration, however, additional Treasury financing would be required.

Uses of the New Funds. The Bush plan would provide about $105 billion in cash over the 1989-1994 period to cover the case resolution costs associated with closing hundreds of thrifts. This amount is about $65 billion more than was assumed in the Reagan budget estimates. CBO estimates that about $22 billion of that increase would be used to pay off existing FSLIC notes and to substitute for notes or other borrowing under the Reagan budget. The plan assumes that about half the cash from REFCORP would be used for assisted acquisitions, and the remainder for liquidations, and that no new FSLIC notes would be issued.

In addition, about $17 billion would be spent over the five years on interest on the REFCORP bonds, while interest on notes would be reduced by about $4 billion because fewer notes would be issued. About $6 billion would be invested in zero coupon Treasury securities to cover the principal on the REFCORP bonds, and $3 billion would be available to bolster FSLIC's reserves.

In present value terms, the case resolution funds and additional capital reserves provided under the Bush plan--when combined with the resources remaining under the Reagan budget assumption and net of proceeds from liquidations--would be around $85 billion.

FDIC Assessments. The Administration is also proposing to raise the insurance premiums paid to FDIC by insured banks from $0.83 per $1,000 in deposits to $1.50 by 1991. By Administration estimates, this increase would give FDIC an additional $7.9 billion over the 1990-1994 period, to be used to increase its reserves for future bank failures. These additional receipts would reduce the deficit over this period, but would not be used to assist failed thrifts, to support the FSLIC fund, or to pay any of the cost of REFCORP bonds.

Alternative Budget Treatments

The Administration's proposal, like the existing FICO arrangement, is structured to minimize the budgetary impact in the initial years and to spread the costs over many future years. The proposal would accomplish this by establishing REFCORP as an off-budget entity and by treating the $50 billion raised by REFCORP as offsetting collections to FSLIC or RTC. As shown in Table 7, this solution would result in large collections offsetting heavy spending in 1989, 1990, and 1991, with a relatively small net effect on outlays. Disbursements by FSLIC and RTC would total over $87 billion in that three-year period, but outlays by these agencies would be only $18 billion. (More than half the outlays are for FSLIC notes issued early in fiscal year 1989, before the plan would go into effect.)

The Bush plan, scored in this way, would result in lower outlays than the Reagan budget over the 1990-1994 period--by $0.2 billion in 1990 and by $4.8 billion over the next four years (see Table 8). This reduction in outlays stems, in part, from the increase in the FDIC assessment, which the Administration estimates would bring in close to $8 billion over the five-year period. The savings and loan proposal, excluding the change in FDIC assessments, would increase outlays by $0.7 billion in 1990, and by $5.5 billion over the 1990-1994 period.

Compared with the CBO baseline, the changes under the President's proposal would be much greater--outlay reductions of $8.5 billion in 1990 and of more than $15 billion over the next four years. While President Bush's plan includes about $40 billion more in case resolution outlays than does the CBO baseline, the treatment of the proceeds of the REFCORP bonds as offsetting collections would result in lower net outlays on the federal budget.

These apparent budgetary savings all depend on the treatment of the proceeds of the REFCORP bonds. While the details of the proposal are not fully known, it is possible that REFCORP would not properly be considered off-budget, or even if it is, that the transfer of funds to FSLIC and RTC would be considered agency borrowing. (If FSLIC or RTC receives cash up front from REFCORP, in return for a requirement that it make a stream of payments to REFCORP over time, it could be considered a debt transaction and not an offsetting collection.) Unless the legislation specifies the budgetary treatment, the impact of the Administration's proposal on the budget would be dramatically different if the REFCORP proceeds

TABLE 7. BUDGET TREATMENT OF BUSH PROPOSAL: REFCORP BORROWING OFF-BUDGET
(By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994	1989-1994	1989-1999
FSLIC/RTC Disbursements a/	27.7	33.4	26.0	10.4	11.0	8.2	116.5	141.5
FSLIC/RTC Collections b/	-17.0	-32.0	-20.0	-5.8	-6.3	-5.9	-86.8	-103.6
FSLIC/RTC Net Outlays	10.7	1.4	6.0	4.6	4.7	2.3	29.7	37.9
Treasury Payments for REFCORP Interest c/	0.5	1.4	1.6	0.9	0.8	1.1	6.3	22.0
Additional FDIC Collections	0.0	-0.8	-1.6	-1.7	-1.8	-1.9	-7.9	-19.9
Net Outlays c/	11.1	1.9	6.0	3.8	3.7	1.5	28.1	39.9

SOURCE: Office of Management and Budget.

NOTE: This table assumes that REFCORP is off-budget and that its payments to the FSLIC are treated as offsetting collections as proposed by the Administration.

a. Disbursements include payments for old and new cases, as well as assessment and liquidation income that is used to purchase zero coupon securities and to pay interest on REFCORP bonds.

b. Collections include proceeds from FICO and REFCORP borrowing, plus income from old and new liquidations and current and proposed assessments.

c. This category does not include interest on the $31 billion in Treasury borrowings needed to finance the Administration's proposal from 1989-1994, and on the additional $48 billion needed in the next five years. These additional interest costs to the Treasury would total about $5 billion from 1989-1994 under the Administration's economic assumptions. The Administration's figures also do not include any estimates for any revenue losses to the Treasury resulting from tax benefits.

TABLE 8. THE IMPACT ON OUTLAYS OF PRESIDENT BUSH'S PROPOSAL COMPARED WITH THE REAGAN BUDGET AND CBO BASELINE (By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994	1989-1994
Bush Proposal a/	11.1	1.9	6.0	3.8	3.7	1.5	28.1
Reagan Budget	8.7	2.1	6.6	4.9	4.9	3.4	30.6
Difference: Bush Proposal Less Reagan Budget	2.4	-0.2	-0.6	-1.1	-1.2	-1.9	-2.5
CBO Baseline	13.0	10.4	11.6	6.8	6.5	5.5	53.8
Difference: Bush Proposal Less CBO Baseline	-1.9	-8.5	-5.6	-3.0	-2.8	-4.0	-25.7

SOURCES: Congressional Budget Office; Office of Management and Budget.

a. Figures include additional FDIC assessment income.

are treated as agency borrowing. As shown in Table 9, FSLIC and RTC outlays would total $62 billion in 1989-1991, compared with $18 billion under the Administration's scoring. The outlay differences in subsequent years would be much smaller.

ISSUES FOR THE CONGRESS

A number of issues will arise in evaluating a solution to the thrift crisis. First, it can choose from among a variety of alternative methods to finance the solution. In addition, the Congress will be considering the budgetary impact of a resolution and its implications under the Balanced Budget Act, as amended. Finally, the Congress will be considering regulatory changes that minimize the possibility of a similar crisis occurring in the future. In all of these issues, it is important that the ultimate solution avoid any additional adverse effects on the economy.

Financing a Solution

Although the size of the thrift problem is uncertain, the amount of federal assistance needed is likely to be large. The alternatives for financing the FSLIC rescue through federal assistance include issuing debt, imposing fees and taxes, or combining all three. Each alternative may have different effects on the economy and the financial sector. Continuing to provide tax benefits to acquirers, which is itself a financing method, is another related issue.

Debt Versus Taxes and Fees. Many analysts argue that borrowing represents the more efficient and less disruptive approach to financing the FSLIC rescue. This approach would also provide flexibility should the size of the problem be larger than initially anticipated. Financing with debt is not a complete substitute for fees and taxes, however, since additional revenues from taxes or fees or reduced expenditures will be needed to cover the interest on the new debt. Financing such interest payments with additional debt would casue the overall rescue cost to grow at a compounded rate, and would raise an already large structural deficit.

In view of the need to raise large amounts of funds quickly, raising the full amount through large temporary increases in taxes would not be efficient and would risk disrupting the economy. Major changes in taxes may generate substantial adjustments in private expenditures and could lead to sharp changes in economic activity, whereas financing with debt would not. Debt financing requires relatively small adjustments in tax rates over the life of the debt, rather than large temporary adjustments for a few years.

The debt issued to resolve the insolvent thrifts should not have a significant adverse effect on the economy. The adverse effects to the economy from the thrift crisis have largely occurred already because of the bad investments. That loss is irretrievable. Indeed, a successful rescue should benefit the economy because, in effect, the government will be swapping bad assets at insolvent thrifts with funds that will restore backing for insured deposits.

TABLE 9. ALTERNATIVE BUDGET TREATMENT OF PRESIDENT BUSH'S PROPOSAL: REFCORP BORROWING ON-BUDGET (By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994	1989-1994
FSLIC/RTC Disbursements	27.7	31.7	24.3	10.7	11.3	8.5	114.2
FSLIC/RTC Collections	-7.8	-8.1	-5.8	-6.1	-6.6	-6.2	-40.6
FSLIC/RTC Net Outlays	19.9	23.6	18.5	4.6	4.7	2.3	73.6
Treasury Payments for REFCORP Interest	0.5	1.4	1.6	0.9	0.8	1.1	6.3
Additional FDIC Collections	0.0	-0.8	-1.6	-1.7	-1.8	-1.9	-7.9
Net Outlays a/	20.4	24.2	18.5	3.8	3.7	1.5	72.1

SOURCE: Congressional Budget Office.

NOTE: The table is based on Administration projections of expenditures and receipts for the various items; it does not reflect CBO economic assumptions or any other possible reestimates.

a. This category does not include interest on $31 billion in Treasury borrowings needed to finance the Administration's proposal. These additional interest costs to the Treasury would total about $5 billion from 1989-1994 under the Administration's economic assumptions. The Administration's figures also do not include any estimates for any revenue losses to the Treasury resulting from tax benefits.

The overall effect of the rescue on interest rates is not likely to be large. Interest rates on bonds may increase somewhat if bonds are sold for the rescue, but any such effect should be temporary and not large. The rescue funds will probably be used to purchase income-yielding assets such as government bonds, mortgages, and other types of assets, thereby offsetting any initial rate increase. In addition, interest rates should be held down by a decline in rates on bank and thrift deposits. Since insolvent thrifts would no longer need to offer premium rates to attract ever-increasing deposits to fund their losses, the remaining thrifts could lower what they have to pay depositors.

Issuing Treasury bonds would be cheaper than issuing bonds of government-sponsored enterprises (GSEs) because interest costs are less for Treasury bonds. The higher interest rates on GSE issues represent compensation to investors in these securities for what they perceive to be their lesser liquidity and possibly greater default risk. To the extent that the Congress intends that debt financing be riskless--that is, that it be backed by the full faith and credit of the government--paying interest at these higher rates would be a waste of money. At present, for example, quotes on FICO bond yields are about 70 basis points above those on Treasury bonds of the same maturity; in the past, they have been much higher. A difference of this magnitude implies that a $50 billion issue would cost an additional $350 million annually in interest payments by financing through GSEs. Under the Administration's plan, the difference between GSE bond yields and Treasury bond yields may be less than 70 basis points, perhaps as low as 30 points, because Treasury funds would cover any shortfall on interest payments, and the GSE bond principal would be paid off by zero-coupon Treasury bonds. In addition, the larger size of the bond issue ($50 billion versus $10 billion) will provide greater scope for secondary trading and greater liquidity. If the difference were 30 points, as many analysts expect, the additional cost over Treasury financing could be as low as $150 million annually.

In principle, taxes and fees can be broadly focused, as with income and sales taxes, or they can be narrowly focused, as with mortgage origination fees and premiums on deposits. Broadly applied fees and taxes would match the benefits with the costs of rescue more effectively, since all segments of the economy would bear the burden of the taxes and all would benefit from the improved soundness of financial intermediaries.

Most discussions of narrowly focused taxes have to do with the effects on the industry, which are discussed below. These discussions presuppose that fees are paid by the institutions on which they are levied rather than passed on to depositors through lower rates. It seems unlikely that fees could be passed on in this way because of the intense competition from other investments for funds. A fee that affected both banks and thrifts is more likely to be passed on than a charge levied only on thrifts.

Some analysts view direct fees on banks and thrifts as insurance premiums that should reflect the riskiness of the institutions on which they are levied. This perspective implies that fees should be raised from present levels. While doing so might force some institutions to close, failure to increase the fees might mean that FSLIC reserves would be insufficient to meet future needs.

Forcing some high-risk institutions out of the industry through higher fees might increase the profitability of those that remain. Insolvent firms have engaged in a number of practices that depress the income of even the soundest firms in the industry, and these practices would probably subside when insolvent firms disappear. Insolvent firms, for example, have often made loans at yields below their cost of funds to generate income from loan fees and show a short-run profit. To attract funds, insolvent thrifts have also offered above-market rates on deposits, often described as reflecting "Texas" premiums. Such actions have put pressure on healthy institutions to do the same, thereby reducing their profitability.

The Administration has proposed a temporary increase in insurance fees, after a phased-in increase in capital requirements. Some members of the thrift industry may not be able to meet both. Under the Administration's plan, thrifts would first have to meet a minimum capital requirement of 6 percent of assets by 1991. The ability of many thrifts to meet this requirement depends heavily on adequate economic growth and stable or declining interest rates over the next two years. For the 379 thrifts whose capital is now between zero percent and 3 percent of assets, net operating income for the first nine months of 1988 was actually a loss of $144 million. The 972 thrifts whose capital is between 3 percent and 6 percent of assets, averaging 4.5 percent, had income of $2.4 billion. Only the 1,239 thrifts whose capital already exceeds the 6 percent requirement may be strong enough to meet the capital requirement. Their operating income over the first nine months of 1988 was $2.5 billion.

The Administration also proposes raising insurance premiums on deposits at thrifts for a three-year period beginning in 1991. The extra premiums for thrifts, based on 1988 third quarter data, would reduce pre-tax income by about $45 million annually for those thrifts whose GAAP net worth is between zero percent and 3 percent of assets, by about $100 million for thrifts between 3 percent and 6 percent, and by about $55 million for those above 6 percent.

While profitability and the survival of healthy thrifts would be enhanced by a successful solution to the thrift crisis, there remains the question of how far this will go toward reducing the amount of leverage in the thrift industry. Some thrifts will still be subject to the risk of default should there be a major economic downturn, or another escalation in interest rates as occurred early in this decade. The long-run prospects for the surviving thrifts will depend on the nature of the rescue program, regulatory reforms, the effectiveness of the insurance fund and its regulatory apparatus, and on the degree of competition that thrifts face in deposit-taking and lending.

Continued Use of Tax Benefits. The continued use of tax benefits as part of the solution to the thrift crisis may not be worthwhile because it may not be the least costly approach for the federal government, and because it creates potentially perverse incentives that might harm the industry.

If the number of potential acquirers were large, so that FSLIC were in a better bargaining position, and if FSLIC had reliable information about the current and future tax status of each potential acquirer, it would be able to ensure that its assistance payments reflected nearly the full value of the tax savings. In such a case, the presence of tax benefits would lower the cost of resolution to the FSLIC. At the

same time, it would not change the cost of resolution to the government as a whole --counting tax losses as well as outlays.

In fact, the number of potential acquirers may be small, and FSLIC may be at a disadvantage compared with the acquirers in evaluating the worth of tax benefits. In such cases, the amount of assistance required from FSLIC will not fully reflect the value of the tax benefits, and the cost to the government as a whole would actually increase.

The tax-exempt status of the portion of FSLIC assistance provided in the form of yield maintenance agreements can weaken incentives for acquirers to increase the performance of assets covered by such agreements. As noted previously, increasing such yields would result in reductions in the amount of the yield maintenance payments from FSLIC. Thus, increasing the yield of poorly performing assets might result in substituting a dollar of fully taxed receipts for a dollar of tax-exempt receipts in the form of a yield maintenance payment.

The tax benefits can also give rise to perverse incentives that may work to the detriment of the thrift industry as a whole. For example, it would be desirable for insolvent thrifts to be acquired by those parties who are likely to operate them most efficiently. Yet, rules that facilitate the use of tax-deductible net operating losses and built-in losses could have the unintended effect of awarding the insolvent thrift to the wrong bidder. In particular, the highest bidder may be the one who values the tax consequences of the losses most highly. Thus, the bidding could be dominated by those who have the highest marginal tax rates, rather than those who might operate the thrift most efficiently.

Budgetary Treatment of Debt Financing

The impact on the deficit of issuing debt to resolve insolvent thrifts would depend on the budgetary treatment of the borrowing. At least three alternative budgetary treatments exist:

- Under current budgetary concepts, the expenditure by FSLIC of funds borrowed by the Treasury and the payment of interest on that debt would add dollar for dollar to federal outlays and to the deficit.

- The funds could be borrowed by Treasury, spent by FSLIC, and added to the deficit. At the same time, the Congress could explicitly exempt the increased spending--but not the interest payments--from the excess deficit calculations under the Balanced Budget Act.

- A shell corporation could be created to borrow the funds and transfer the money to FSLIC in a way that eliminates consequences for the deficit.

The first treatment would have the disadvantage of adding substantial amounts to the federal deficit and making it more difficult to meet the Balanced Budget Act deficit targets. On the other hand, the first and second treatments would have several advantages. By including the expenditure of borrowed funds and their interest payments in the budget, they would be consistent with the fundamental budgetary principle that irrevocable commitment of taxpayers' resources should be shown as a budgetary cost at the time the commitment is made. They also would avoid the use of a questionable technique to exclude from the budget disbursements that are widely perceived to be federal expenditures. Finally, as noted above, the creation of a REFCORP-type entity for the purpose of achieving off-budget treatment of some thrift resolution costs would increase the cost of financing the spending by amounts ranging from $100 million to $200 million each year over the next 30 years.

Exempting the use of the borrowed funds from the Balanced Budget Act deficit calculations, as under the second budgetary treatment, also may be justified on the basis of the economic effects of the expenditures. Borrowing to resolve thrifts would not be worrisome, as is most debt incurred by the federal government. Unlike most federal spending, the outlays would not be likely to reduce private investment by diverting private saving to consumption. Instead, they would provide backing for the insured deposits at insolvent thrifts, and would probably be loaned out by the institutions that receive them to finance investments. Thus, funds borrowed by the government would very probably be returned to the lending stream and would not reduce private investment.

In borrowing to finance thrift resolution, the government would, in effect, be swapping good assets for bad assets held by insolvent thrifts. At the same time, the government would be making the implicit liabilities of FSLIC into an explicit liability of the government--that is, it would be exchanging one liability for another liability. Thus, borrowing in this case is similar to asset sales by the government; such sales involve the exchange of one asset for another--cash. Asset sales are generally not counted toward deficit reduction targets.[14] Moreover, borrowing the money would have no permanent structural effect on the deficit beyond the interest payments on the debt issued. On the down side, the second budgetary treatment could create the potential for exempting other federal spending from future Balanced Budget Act deficit calculations.

Under the third treatment, the President and the Congress could designate this new corporation as a government-sponsored enterprise, in which case its operations would not be included in the federal budget. FICO now enjoys this status. The funds borrowed by the shell corporation and transferred to the government would offset the increased FSLIC spending to resolve insolvent thrifts dollar for dollar, with no effect on the deficit. To the extent that Treasury payments to the corporation would cover the interest payments on its debt, the cost of financing the expenditures with debt would appear as outlays in the budget. The Administration intends this third budgetary treatment for REFCORP, the shell corporation it has

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14. See Congressional Research Service, "FSLIC, the Budget, and the Economy," January 12, 1989.

proposed. It is unclear, however, whether the proposal fulfills the conditions necessary for the receipt of funds that REFCORP borrowed not to be considered borrowing by the federal agency that would receive the money.

The third budgetary treatment would have the advantages of allowing the government to resolve the insolvent thrifts without increasing the acknowledged budget deficit significantly, without making the achievement of the Balanced Budget Act deficit targets more difficult, and without setting a precedent of explicitly exempting any spending from the deficit target calculations. To the extent that Treasury disbursements to cover the interest on the shell corporation's debt appeared in the budget as outlays, this budgetary treatment would be consistent with the small macroeconomic effects of the expenditures and the cost to taxpayers of financing the spending with borrowing. On the other hand, sponsorship of borrowing by GSEs will, as noted before, itself impose significant extra dollar costs on the thrift rescue program.

Compared with the second budgetary treatment designating REFCORP or a similar borrowing entity as a government-sponsored enterprise could, in the long run, be even more damaging to the integrity of the unified budget, the meaning of the budgetary deficit, and deficit reduction efforts. Both the FICO case and the shell corporation created in 1987 to assist the Farm Credit System suggest that creating new government-sponsored enterprises does more than offer an off-budget means of financing unrecognized federal financial obligations. Such enterprises provide a way to transfer the functions and spending of existing government agencies off-budget. Off-budget agencies have the potential for losing the greater accountability to the President and the Congress as well as the stricter budgetary control that placement in the Executive Branch affords. For example, the Committee on Ways and Means considered a bill during the 100th Congress, H.R. 3392, that would have created a new government-sponsored enterprise, the Corporation for Small Business Investment (COSBI), to take over loan and guarantee functions now performed by the Small Business Administration. Thus, the third budgetary treatment could also accelerate a current trend toward attempting to transfer existing government functions to government-sponsored enterprises. This result would be to the detriment of federal budgetary control and Executive and Legislative Branch oversight.

The issue of appropriate budgetary treatment is ultimately not a matter to be settled by technicians at CBO or the Office of Management and Budget, but a political question to be decided by the Congress and the President. The Congress could address the issue in any legislation that provides additional resources to FSLIC by explicitly stipulating the budgetary treatment of any debt financing of an assistance plan.

Avoiding Future Problems

Government deposit insurance can encourage financial intermediaries to use deposits imprudently. Thus, as long as the government makes a commitment to stand behind deposits at insured financial institutions, some type of regulatory oversight is necessary. Had the government monitored the thrift industry more closely and taken action more quickly, the current problem would not have become so large. Of

course, increased oversight and more rigorous examination will require additional resources.

The Bush Administration proposes a significant overhaul of the existing regulatory apparatus. The first step, which essentially already has been taken, is to give FDIC, the insurer of deposits at commercial banks, authority over insolvent thrifts. Previously, FSLIC was under the authority of the Bank Board, which also regulates the industry. The Administration further recommends that the Bank Board no longer operate as an independent agency. It advocates transferring the regulatory responsibilities to the Department of the Treasury, which also has much of the authority to regulate the banking industry. Finally, the Administration proposes that in certain critical respects--most notably the amount of capital they must maintain --thrifts be treated more like banks.

Since federal deposit insurance reduces the incentive of thrifts to behave prudently, the most important priority in reforming the regulatory system is taking steps to reduce the likelihood of a financial institution becoming insolvent. One way to reduce the likelihood of insolvency is to require thrifts to maintain a higher level of capital relative to their liabilities--that is, to require the owners to have a substantial amount of their money at stake. The Bush Administration proposes that by 1991, thrifts must maintain capital not less than 6 percent of their assets, twice the current level, but the same standard that banks must currently meet. A higher capital standard not only reduces the incentives to make risky investments, but it also provides a cushion for the insurer in case the institution experiences financial difficulty.

Since some assets are inherently more risky than others, some analysts have proposed using risk-based capital standards--requiring a higher level of capital for those classes of assets in which institutions are most likely to experience a loss. Currently, firms have to maintain the same reserve requirements regardless of their mix of assets. Such risk-based requirements essentially increase the cost of acquiring risky assets. Alternatively, the insurers could levy a higher deposit insurance premium when firms hold riskier assets. In that case, the cost of risky assets will also be borne directly by the institutions acquiring them. But, unlike the case with risk-based capital requirements, the increased premiums would provide higher reserves for the insurance fund. In other words, with risk-based deposit premiums, the insurance fund and not the individual institutions, would maintain the greater reserves.

Although it is clearly desirable for thrifts to maintain a higher capital standard, a substantial segment of the industry will have difficulty meeting the goal. As previously noted, a large segment of the industry, although solvent, is not financially strong. In fact, only about half of the 2,600 solvent institutions (accounting for 40 percent of deposits at solvent thrifts) already meet the new standard. Many of the remaining institutions will be unable to attract the additional capital. Enforcing the standard may result in a substantial number of liquidations and mergers. Since these institutions are solvent, the cost to the government should largely be administrative. Increased capital-asset ratios in the industry should relieve the widely perceived overcapacity in the industry. With higher capital standards, operating margins in the industry should improve, and the quality of assets that the thrifts acquired should also improve.

Encouraging a financial institution to hold a diversified portfolio of assets would make it less likely that it will become insolvent. Diversity, if done prudently, lessens the likelihood that the poor performance of a particular region or industry would erode the financial strength of an institution. Current federal and state policies that discourage expanded geographic coverage are, at least in this respect, counterproductive.

A revamped regulatory system should also permit regulators to identify at an early stage institutions that are incurring financial difficulty and enable them to take appropriate action quickly. A high capital standard allows a thrift to incur substantial deterioration before it becomes insolvent. In addition, regulators should be permitted to take action well before a thrift becomes insolvent. The cost to the insurers of liquidating or merging solvent institutions is less than the cost of resolving insolvent institutions.

While comprehensive regulatory reform is important, it is probably not as pressing as resolving the existing insolvent institutions. In the first place, because insolvent institutions continually must attract increasing amounts of deposits just to fund their current obligations, they bid up the costs of solvent thrifts that must compete with them. This increased cost makes it more difficult for viable institutions to raise necessary levels of capital; in fact, it may ultimately force more institutions toward insolvency. In addition, the Bank Board is taking steps both to increase the industry's capital requirements and to monitor the behavior of individual thrifts more closely.